Internal Revenue Service

memorandum

CC:INTL-0146-89
Br1:WEWilliams

date:

to: Ms. Beth L. Williams, International Special Trial Attorney
Midwest Region

from: Chief, Branch No. 1
Associate Chief Counsel (International) CC:INTL:1

subject: [redacted]

This refers to your memorandum dated February 16, 1989, by which you forwarded two requests for informal technical advice. We are responding to one of your requests, the cost sharing/offset question, because you request that it be given expedited consideration. You have also indicated that if this issue is resolved in the manner requested by the taxpayer, apparently on an aggregate basis, it will more than offset all adjustments relating to the second issue, the currency loss question.[1]/

For the reasons stated below, we believe that the taxpayer is legally correct that there are circumstances under which a taxpayer may offset the IRS's I.R.C. § 482 adjustments by section 482 adjustments claimed by the taxpayer. However, taxpayer's argument rests on the existence of a valid cost sharing agreement, and because the existence of such an agreement under the facts of this case is directly contrary to a Treasury Regulation, the IRS's primary position must be that a cost sharing agreement does not exist. However, under section 1.482-2(b)(ii)(b) of the Regulations, and in the absence of a valid cost sharing agreement, a taxpayer is generally entitled to compensation for the unreimbursed value of assists (the purported cost sharing payments), and such unreimbursed value can form the basis for an offset. As will

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[1]/ On a subsidiary-by-subsidiary and year-by-year basis, the IRS's section 482 adjustments would be reduced or eliminated by the following offsets claimed by [redacted]

	[redacted]		[redacted]	
Subsidiary	§ 482 Adjustment	Offset Claimed by [redacted]	§ 482 Adjustment	Offset Claimed by [redacted]
[redacted]	$[redacted]	$[redacted]	$[redacted]	$[redacted]

be explained below, if taxpayer is correct that its sale prices to its subsidiaries did not include an increment for its research and development costs, taxpayer may offset the section 482 price adjustments by the value of the assists it received from the subsidiaries.

Even if taxpayer establishes that it met the requirements for a cost sharing agreement under the applicable Treasury Regulations, it would be required to establish that the prices of products it sold to its subsidiaries were greater than arm's length and that the alleged comparables that taxpayer contends establish uncontrolled, fair market prices for its products sold to its subsidiaries have been appropriately selected and adjusted.

General Facts

The requests for informal technical advice relate to [redacted], to which the IRS issued a statutory notice of deficiency on [redacted], for taxable years ended [redacted] and [redacted]. [redacted] filed a Tax Court petition on [redacted]. [redacted] is a U.S. corporation engaged in the manufacture of, among other products, [redacted]. During the fiscal years in question, [redacted] sold its [redacted] products in foreign markets through [redacted] wholly-owned foreign corporations: [redacted] ([redacted], [redacted], and [redacted]); [redacted] ([redacted] and [redacted]); [redacted] ([redacted] and [redacted]); and [redacted] ([redacted]. These corporations operated as assembler/manufacturers and/or as distributors of [redacted]s products. Apparently, [redacted] sold its subsidiaries the [redacted], and the subsidiaries manufactured/assembled the [redacted].

It is [redacted]'s contention that it establishes transfer prices to its subsidiaries on a cost plus basis based on a standard costing method that does not include research and development expenses in manufacturing costs of sales for purposes of the sales price computation. With respect to the research and development that [redacted] conducted [redacted] in [redacted], Illinois, and at facilities in [redacted], Wisconsin, [redacted] contends that it has had oral cost sharing agreements with [redacted], [redacted], [redacted], and [redacted] since the [redacted]s covering manufacturing intangibles. According to [redacted] cost sharing payments of the respective subsidiaries were computed by reference to the standard manufacturing costs for finished products produced by each affiliate over [redacted]s [redacted] standard manufacturing costs for finished products times [redacted]'s annual research and development expenses. Specifically, this method of computing the cost sharing payments was as follows:

$$\frac{\text{Affiliate's standard costs for finished [redacted]}}{\text{[redacted] group standard costs for finished [redacted]}} \times \text{[redacted]'s R \& D} = \text{Affiliate's cost sharing payment}$$

[redacted] states that the cost sharing payments entitled the subsidiaries to use technology (manufacturing intangibles), resulting from [redacted]'s research, in the subsidiary's geographic area.

[redacted] contends that its subsidiaries were billed separately, on a monthly basis, for the cost sharing payments and, as previously noted, that none of the costs of the research and development were included in [redacted]'s sales prices of products. [redacted] asserts that its system of billing separately for the research and development stands in contrast to the system used by Japanese manufacturers of products in competition with [redacted]'s products. In this regard, the Japanese manufacturers were apparently [redacted]'s major competitors in all markets during the years in issue.

[redacted] asserts that Japanese manufacturers sell their products worldwide through unrelated distributors and that the manufacturers' sale prices are determined by and include manufacturing costs, research expenses, and profit markup. That is, according to [redacted], Japanese manufacturers recover their research and development expenses in their sale prices in unrelated sales to worldwide distributors and not by billing the vendees separately for the research and development.

The statutory notice of deficiency issued to [redacted] made a number of adjustments including allocations of income, under the authority of I.R.C. § 482, attributable to deductions claimed by [redacted] for rebates it made to [redacted]; to an arm's length interest rate determination on receivables owed [redacted] by [redacted] and to technical service fee income reported by [redacted] but determined by the IRS to be income of [redacted]. None of these adjustments related to the transfer prices of [redacted] to its subsidiaries.

[redacted] contends that it analyzed its transfer prices to its [redacted] wholly-owned manufacturer/distributors against "existing marketing data", apparently mostly Japanese competitors that, according to [redacted], included research and development costs in their sale prices to worldwide distributors. According to [redacted], it did the following:

1. Identified products manufactured and sold by competitors, in arm's length sales, comparable to those sold by [redacted]. If comparable products or unrelated sales of comparable products could not be identified by [redacted], its analysis of whether its transfer prices were fair market prices (or, as [redacted]

concluded, above fair market price) was based on its subsidiaries' sales to unrelated parties.

2. Utilizing the unrelated sale prices of comparable products, [redacted] adjusted these prices to reflect any differences between the market level of its sales and the market level of the comparable product sales. Apparently, no data was available to [redacted] as to sale prices between Japanese manufacturers and unrelated distributors; all unrelated sale price data involved sales between distributors (unrelated to [redacted] or by [redacted] s subsidiaries to unrelated dealers) and dealers or at the retail level.

3. The adjustments to the sale prices utilized by [redacted] for developing an arm's length manufacturer's sale price included decreases for what [redacted] determined to be normal profit margins for sales at distributor and retail levels.

4. [redacted] increased its actual sale prices to its [redacted] subsidiaries by the particular subsidiary's cost sharing payment allocable to the sale prices.

5. [redacted] compared its transfer prices, as increased by cost sharing payments made by its subsidiaries, with the unrelated sale prices that it had constructed and concluded that its transfer prices substantially exceeded arm's length prices in comparable uncontrolled sales.

It is the difference between its transfer price, as increased by an allocable share of the cost sharing payment, and the fair market price constructed by [redacted] that [redacted] contends must be allowed by the IRS as an offset against the section 482 adjustments.

1. Legal basis for offset

I.R.C. § 482 authorizes the Secretary of the Treasury to allocate income, deductions, credits, or allowances between controlled entities if he determines that such an allocation is necessary to prevent evasion of taxes or clearly to reflect the true incomes of the controlled enterprises. The purpose of section 482 is to prevent the artificial shifting of the true net incomes of controlled taxpayers by placing controlled taxpayers on a parity with uncontrolled, unrelated taxpayers. Commissioner v. First Security Bank, 405 U.S. 394, 400 (1972). The Secretary's authority under section 482 is broad (see, e.g., PPG Industries v. Commissioner, 55 T.C. 928, 990-991 (1970), and an allocation must be sustained absent a showing that the Secretary has abused his discretion. Paccar, Inc. v. Commissioner, 85 T.C. 754, 787 (1985), aff'd 849 F.2d 393 (9th Cir. 1988). A taxpayer, thus, bears the heavier than normal burden of proving that a section 482 allocation is arbitrary, capricious, or unreasonable. Your Host, Inc. v. Commissioner, 489 F.2d 957 (2d Cir. 1973). Whether the Secretary has exceeded his authority is a question of fact. American Terrazzo Strip Co. v. Commissioner, 56 T.C. 961, 971 (1971).

Section 1.482-1(b)(3) of the Treasury Regulations states, in part, that "[s]ection 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the district director to apply such provisions." Thus, although utilization of section 482 is generally at the discretion of the Secretary, sections 1.482-1(d)(3) and 1.482-2(d)(1)(ii)(b) of the Regulations specifically authorize a taxpayer to offset, against section 482 allocations, amounts arising from other nonarm's length transactions between the controlled entities that are the subject of the IRS's allocation. The latter Regulation provides, in pertinent part, that

> [i]n making distributions, apportionments, or allocations between two members of a group of controlled entities with respect to particular transactions, the district director ... shall consider the effect of any other nonarm's length transaction between them in the taxable year which, if taken into account, would result in a setoff against any allocation which would otherwise be made, provided the taxpayer is able to establish with reasonable specificity that the transaction was not at arm's length and the amount of the appropriate arm's length charge. ... For example, assume that one member of a group performs services which benefit a second member, which would in itself require an allocation to reflect an arm's length charge for the performance of such services. Assume further that the first member can establish that during the same taxable year the second member engages in other nonarm's length transactions which benefit the first member, such as by selling products to the first member at a discount, or purchasing products from the first member at a premium, or paying royalties to the first member in an excessive amount. In such case, the value of the benefits received by the first member as a result of the other activities will be set off against the allocation which would otherwise be made. ... In order to establish that a set-off to the adjustments proposed by the district director is appropriate, the taxpayer must notify the district director of the basis of any claimed set-off at any time before the expiration of the period ending 30 days after the date of a letter by which the district director transmits an examination report notifying the taxpayer of proposed adjustments or before July 16, 1968, whichever is later.

Therefore, the IRS position is clear that a taxpayer may offset adjustments, attributable to section 482 allocations, by the effect of other nonarm's length transactions but only to the extent of the section 482 adjustments.[2] Furthermore, offsets claimed by a taxpayer under section 1.482-2(d)(1)(ii)(b) of the Regulations must relate to transactions between the same related parties involved in the Secretary's section 482 adjustments and be for the same year(s) as the Secretary's adjustments. In addition to these prerequisites for allowance of an offset, there are the timely notification and burden of proof requirements.

Section 1.482-2(d)(1)(ii)(b) of the Regulations provides that the IRS may make allocations of income when the rendering of assists is other than at a fair market price that would have prevailed in an arm's length transaction; the Regulation also provides for offsets of assists rendered a person in development of an intangible. Such "assistance shall be allowed as a set-off against any allocation that the district director may make ... as a result of the transfer of the intangible property to the entity rendering the assistance."

Rev. Proc. 70-8, 1970-1 C.B. 434, prescribes the procedure to be used by a taxpayer to assert an offset, claimed under section 1.482-1(d)(3) of the Regulations, to a section 482 allocation. As to the timely notification requirement, [redacted] claims that it was advised of the section 482 allocations in a revenue agent's report dated [redacted] and that [redacted] claimed the offsets in issue in a letter to the IRS dated [redacted]. If these allegations are verified, [redacted] satisfies the timely notification prerequisites of the Regulation and the revenue procedure.

2. Invalidity of cost sharing agreement

Section 1.482-2(d)(4) of the Treasury Regulations defines a valid cost sharing arrangement as follows:

> an agreement, in writing, between two or more members of a group of controlled entities providing for the sharing of the costs and risks of developing intangible property in return for a specified interest in the intangible property that may be produced. In order for the

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[2]/ The legislative history of the amendments to section 482 in the Tax Reform Act of 1986, P.L. 99-514, states that "Congress did not intend to change principles that would permit offsets or other adjustments to reflect the tax impact of the taxpayer's transactions as a whole." General Explanation of the Tax Reform Act of 1986, prepared by the Staff of the Joint Committee on Taxation, page 1017.

> arrangement to qualify as a bona fide arrangement, it must reflect an effort in good faith by the participating members to bear their respective shares of all the costs and risks of development on an arm's length basis. In order for the sharing of costs and risks to be considered on an arm's length basis, the terms and conditions must be comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement. <u>If an oral cost sharing arrangement, entered into prior to April 16, 1968, and continued in effect after that date, is otherwise in compliance with the standards prescribed in this subparagraph, it shall constitute a bona fide cost sharing arrangement if it is reduced to writing prior to January 1, 1969.</u> [Emphasis added.]

The requirement in the Regulation that a valid cost sharing agreement be in writing, or reduced to writing by January 1, 1969 in the case of an oral agreement entered into prior to April 16, 1968, is clear. While we have found no authority discussing this requirement, section 1.482-2(d)(4) of the Regulations has been cited, with no indication of Congressional disapproval, in the legislative history of at least one amendment of the Code. For example, the legislative history of section 131 of the Deficit Reduction Act of 1984, P.L. 98-369, that amended I.R.C. § 367, in explaining that the rules for transfers of intangibles do not apply to cost sharing agreements, states as follows:

> In addition, the special rule for intangibles will have no application to bona fide cost-sharing arrangements (under which research and development expenditures are shared by affiliates as or before they are incurred, instead of being recouped by licensing or selling the intangible after successful development). <u>See generally</u> Treas. reg. sec. 1.482-2(d)(4) (relating to the application of section 482 where a member of a group of controlled entities acquires an interest in intangible property as a participating party in a bona fide cost-sharing arrangement with respect to the development of such property).

General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, prepared by the Staff of the Joint Committee On Taxation, page 433.

It is our view that the requirement that a cost sharing agreement be in writing is necessary to establish that there was actually an agreement to share costs, risks, and benefits on a specific basis; that each party to the agreement bore its respective costs and received the benefits that it was entitled to under the agreement; and that the agreement was one that would have been entered into by similarly-situated unrelated parties dealing at arm's length.

While there is substantial authority that failure to comply with a legislative regulation dealing with a procedural matter (e.g., the procedure and timing of making an election) is fatal to any benefits claimed by the taxpayer that could result from the election, the law is less settled with respect to failure to comply with an interpretative procedural regulation. See, e.g., Leonhard v. Commissioner, 92 T.C. #54 (April 27, 1989) (failure to make a timely section 911 election in accordance with what the Tax Court characterized as a legislative regulation is fatal to a section 911 exclusion).* In the latter circumstances, the courts are more apt to apply a substantial compliance test. In Taylor v. Commissioner, 67 T.C. 1071, 1077-1078 (1977), the court observed:

> The test for determining the applicability of the substantial compliance doctrine has been the subject of a myriad of cases. The critical question to be answered is whether the requirements relate "to the substance or essence of the statute." [Citation omitted.] If so, strict adherence to all statutory and regulatory requirements is a precondition to an effective election. [Citation omitted.] On the other hand, if the requirements are procedural or directory in that they are not of the essence of the thing to be done but are given with a view to the orderly conduct of business, they may be fulfilled by substantial, if not strict compliance. [Citations omitted.]

The division between mandatory and directory regulations was described in Vaughn v. John C. Winston Co., 83 F.2d 370, 372 (10th Cir. 1936), as follows:

> Whether a statutory requirement is mandatory in the sense that failure to comply therewith vitiates the action taken, or directory, can only be determined by ascertaining the legislative intent. If a requirement is so essential a part of the plan that the legislative intent would be frustrated by a noncompliance, then it is mandatory. But if the requirement is a detail of procedure which does not go to the substance of the thing done, then it is directory, and noncompliance does not invalidate the act.

We think that a creditable argument can be made that without a requirement that a cost sharing agreement be in writing, there will be considerable room for abuse in that taxpayers can manipulate the amount of intercompany payments, will be unable to establish that there was actually an agreement to share costs, risks, and benefits on a specific basis; that each party to the agreement bore its respective costs and received the benefits that it was entitled to under the agreement; and that the agreement was one that would have been entered into by similarly-situated unrelated parties dealing at arm's length.

3. Assuming the absence of a valid cost sharing agreement

Assuming the absence of a valid cost sharing agreement, the only other basis for [redacted] to argue for an offset to the IRS's section 482 adjustments is under section 1.482-2(d)(1)(ii)(b) of the Regulations. As explained below, we think that taxpayer is likely to prevail on this issue and that the IRS must allow an offset to the extent of the unreimbursed assists paid by the subsidiaries to [redacted]

Section 1.482-2(d)(1)(ii)(a) of the Regulations states that in the absence of a valid cost sharing agreement, where one member of a group of entities undertakes development of an intangible for the group, no allocation is made, except under subparagraph (c), "until such time as any property developed ... is or is deemed to be transferred, sold, assigned, loaned, or otherwise made available in any manner by the developer to a related entity in a transfer subject to the rules of the ..." Regulation.

Subparagraph (b) of the Regulation describes the following exception to the "no allocation" rule in subparagraph (a):

> Where one member of a group renders assistance in the form of loans, services, or the use of tangible or intangible property to a developer in connection with an attempt to develop intangible property, the amount of any allocation that may be appropriate with respect to such assistance shall be determined in accordance with the rules of the appropriate paragraph or paragraphs of this section."

Thus, pursuant to this Regulation the IRS may allocate income to the provider of an assist to reflect the fair market value of the assist. However, in a case such as the one here, use of this Regulation would require allocation of income from [redacted] to its subsidiaries, if the IRS were to determine that a subsidiary did not receive a fair market price for its assist. The IRS would not usually make an allocation that has the effect of decreasing the U.S. tax base, but it would provide the basis for a setoff.

Subparagraph (b) also provides that if the IRS does not make an allocation in the case of the rendering of an assist for less than a fair market price (e.g., if a subsidiary makes unreimbursed cash payments as assists to a developer),

> the value of the assistance shall be allowed as a set-off against any allocation that the district director may make under this paragraph as a result of the transfer of the intangible property to the entity rendering the assistance.

In this case, [redacted] argues that it is entitled to offsets against the section 482 allocations made by the IRS for the amount of the payments that its subsidiaries made to [redacted] allegedly as cost sharing payments. It is [redacted]'s contention that it did not reimburse the subsidiaries for these payments. It does not appear that we can reject [redacted]s position on the ground that reimbursement for the "cost sharing" was already in effect made by eliminating research and development from its cost plus sale price calculations.

Section 471(a) authorizes the Secretary, when the use of inventories is necessary to determine the income of a taxpayer, to prescribe the basis for computing the value of the inventory that conforms "as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income." Section 1.471-11(a) of the Regulations, dealing with inventories of manufacturers, requires inclusion of both direct and indirect production costs in computation of inventoriable costs in accordance with the "full absorption" method of inventory costing. However, section 1.471-11(c)(2)(ii) of the Regulations specifically provides that

> [c]osts which are not required to be included for tax purposes in the computation of the amount of inventoriable costs (regardless of their treatment by a taxpayer in his financial reports) include:
>
> * * *
>
> (f) Research and experimental expenses including engineering and product development expenses ....

Therefore, [redacted] appropriately excluded research and development costs from its costs in computing its sale prices to the subsidiaries.

Furthermore, to the extent that the subsidiaries' payments to [redacted] were not otherwise reimbursed, an offset to the IRS's section 482 allocations is permitted by section 1.482-2(d)(1)(ii)(b).

4. <u>Assuming a valid cost sharing agreement</u>

Allowance of an offset to the IRS's section 482 adjustment for the value of the subsidiaries' assists will apparently eliminate the adjustment. However, we will give you our views on [redacted]'s argument that it had a valid cost sharing agreement with the subsidiaries merely for the sake of completeness. If [redacted] were to establish the existence and terms of a cost sharing agreement between it and its subsidiaries, [redacted] must establish that the terms of the agreement are comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement. Treas. Reg. § 1.482-2(d)(4). That is, [redacted] must establish that two unrelated parties under a similar set of facts and circumstances would enter into a similar agreement in which the terms of the costs and risks to be shared, in return for their respective specified interests to be derived from any intangibles produced, would be the same as the agreement between [redacted] and its subsidiaries.

In this regard, [redacted] states that the cost sharing agreement entitled each subsidiary to use all of the manufacturing intangibles developed by [redacted] in the subsidiary's particular geographic market. If a subsidiary engaged in little or no manufacturing, however, and was merely a distributor of [redacted]'s products, there would be no requirement for the subsidiary to make a cost sharing payment to [redacted] even though such a subsidiary would get the full benefit of [redacted]'s research and development. This may be an indication that the agreement was not at arm's length, in that it penalized the subsidiaries that did a high proportion of manufacturing. In any event, we think that you will need the services of an economist and/or an engineer to evaluate evidence submitted by [redacted] in order to determine whether [redacted]'s alleged cost sharing agreement was comparable to an arm's length arrangement.

a. <u>Whether [redacted]'s sale prices of products to its subsidiaries were arm's length prices</u>

[redacted] argues that its sale prices to its four wholly-owned subsidiary manufacturer/distributors were comparable to arm's length prices even before taking into consideration the cost sharing payments. As pointed out previously, [redacted] used a cost plus method of computing its transfer price; however, the costs that went into this computation did not include [redacted]'s research and development expenses which were recovered by the separate cost sharing payments. [redacted]'s position that its sale prices to its subsidiaries (not considering the cost sharing payments), were fair market prices is, in our view, questionable. That is, if [redacted]'s transfer prices did, in fact, not include an increment for research and development, these prices should *prima facie* be less than fair market price. Thus, [redacted] should have to meet a substantial burden of proof to demonstrate that the cost plus method generated arm's length prices even though all research and development costs were omitted from the calculation.

Furthermore, assuming that [redacted] establishes that there existed a valid cost sharing agreement comparable to an agreement that would have prevailed between unrelated parties, it is our view that there is a basic fallacy in [redacted]'s argument that the cost sharing payment can be added to the invoice prices to arrive at the actual sale prices to the subsidiaries. A cost sharing payment is made for an ownership interest in intangibles and for the right to use these intangibles without payment of a royalty. As will be explained below, an interest in an intangible requires a decrease or discount in the price of a product utilizing the intangible when the product is sold to a party that has acquired the interest through a cost sharing payment. This discount would be equal to the value of the intangible embedded in the product. If the research and development effort was unsuccessful, the value of the intangible could be zero. If the research and development effort was highly successful, the intangible could represent the majority of the value of the product. However, in no event could the amount of the cost sharing payment be considered as part of the purchase price of the product, as the taxpayer contends, because the cost sharing payment has no direct relationship to the purchase price for the products involved.

[redacted] must, therefore, establish what intangibles were developed under the cost sharing agreements from their inception, the precise interest that each subsidiary obtained in each such intangible, and which intangibles were embedded in the products that [redacted] sold to its subsidiaries. If, as is likely, the products that [redacted] sold to its subsidiaries contained manufacturing intangibles developed in connection with the cost sharing agreements (assuming that such agreements existed), the inter-company sale prices should have excluded the value of the intangibles, or the portion of any intangibles, that were owned by the subsidiary/vendee. If such value was not excluded, the subsidiary was paying for the intangible twice - once in the cost sharing payment and again in the purchase price. Under such circumstances, assuming the inter-company price would have been at arm's length in the absence of a cost sharing agreement, the inter-company price would have been overstated by the value of the subsidiary-owned intangibles embedded in the products. As was the case with evaluation of any cost sharing arrangement between [redacted] and its subsidiaries, we believe that it will be necessary to engage the services of an economist and/or engineer to evaluate any evidence provided by [redacted] concerning these matters.

It should also be noted that in proving that the price that [redacted] charged its subsidiaries was at arm's length, if the cost sharing arrangement is ignored, and thus at more than arm's length if the cost sharing agreement is taken into account, [redacted] is essentially relying on the comparable uncontrolled price method and, for some of its products for which a comparable was unavailable, on a resale price method. According to [redacted] its application of these methods established what fair market prices for manufacturers in uncontrolled sales (sales by Japanese competitors of [redacted] as well as on actual sales of [redacted]s products by its distributors in arm's length transactions) would have been.

b. Comparable uncontrolled price method

Section 1.482-2(e)(2)(ii) of the Regulations provides, in part, that

> [u]ncontrolled sales are considered comparable to controlled sales if the physical property and circumstances involved in the uncontrolled sales are identical to the physical property and circumstances involved in the controlled sales, or if such properties and circumstances are so nearly identical that any differences either have no effect on price, or such differences can be reflected by a reasonable number of adjustments to the price of uncontrolled sales. For this purpose, differences can be reflected by adjusting prices only where such differences have a definite and reasonably ascertainable effect on price. ... Some of the differences which may affect the price of property are differences in the quality of the product, terms of sale, intangible property associated with the sale, time of sale, and the level of the market and the geographic market in which the sale takes place. Whether and to what extent differences in the various properties and circumstances affect price, and whether differences render sales noncomparable, depends upon the particular circumstances and property involved.

The determination of what, if any, adjustments are necessary to render an arm's length sale a comparable of a controlled sale is factual. See, e.g., Rev. Rul. 87-71, 1987-2 C.B. 148, involving differences in geographic markets and the IRS's conclusion that in this particular case adjustments could not be reasonably ascertained that would make the uncontrolled sales comparable to the controlled sales. It is likely that the same result would be reached as to comparison of sales made at different market levels or sales of products involving wholly different trademarks with varying values, as here. There is generally no reasonable method of determining the effect on sales prices (and to make adjustments for purposes of developing comparables) when such differences are present to a significant extent.

A result similar to that in Rev. Rul. 87-71 was reached in Paccar, Inc. v. Commissioner, 85 T.C. 754 (1985), aff'd 949 F.2d 393 (9th Cir. 1988), in which the taxpayer sought to establish that its sales to unrelated domestic distributors of truck units and replacement parts were comparable to its sales of the same products to its wholly-owned domestic subsidiary, Paccint, that distributed the taxpayer's products in foreign markets. The Tax Court rejected the taxpayer's argument after concluding that the uncontrolled sales were not comparable because of the difference in geographic markets, the different terms of sale imposed by taxpayer on sales to Paccint in contrast to the terms imposed on sales to the unrelated U.S. distributors, and the different distribution levels of the two classes of sales.

In Eli Lilly & Co. v. Commissioner, 84 T.C. 996 (1985), aff'd in part, rev'd in part, and remd. ___ F.2d ___ (7th Cir. 1988), however, the Tax Court, for one of the three years in issue, concluded that a comparable was established for Lilly P.R.'s sales of Darvon to Lilly by adjusting the sale price of a generic product sold to Smith Kline & French Laboratories, Inc. by an unrelated manufacturer (Milan Pharmaceuticals, Inc.). The adjustments made by the Tax Court to Milan's sale price were for raw materials supplied to Milan by Smith Kline; differences in credit terms offered by Milan and Lilly P.R.; samples; the higher quality of the Lilly product; and the value of Lilly P.R.'s napsylate patent, market level, risk, technical assistance, and research and development. The Seventh Circuit affirmed the Tax Court's use of Milan's unrelated sales of the generic product as a comparable. However, the court concluded that one of the adjustments that the Tax Court made in the Milan sale price was incorrect. Specifically, the appellate court determined that the Milan sale price should not have been adjusted by an amount representing a contribution to Lilly's on-going general research and development unrelated to Darvon products. Lilly as well as the Paccar case illustrate the factual analysis required in determining whether an uncontrolled sale price can be adjusted so as to be comparable to a taxpayer's controlled sale price.

Furthermore, the effect on prices of a significant difference in the value of intangibles associated with alleged comparables is generally not reasonably ascertainable, and such difference would normally render the uncontrolled sales noncomparable to the controlled sales. Treas. Reg. § 1.482-2(e)(2)(ii), Example (2). In this case, [redacted] s [redacted] were apparently sold under the [redacted] and [redacted] labels, trademarks widely recognized for quality and reliability. It is quite unlikely, in our view, that [redacted] will be able to establish a precisely ascertainable effect on sale prices for differences in geographic markets and distribution levels of its comparables, and that adjustments are unnecessary for the physical differences in the products (they were similar but not identical) and for differences in intangibles such as trademarks and any relevant patents.

c. Resale price method

Section 1.482-2(e)(1)(ii) of the Regulations states that if there are no comparable uncontrolled sales for establishing an uncontrolled fair market price, the next most accurate method is the resale price method. Furthermore, even where all of the standards for the application of the resale price method are not satisfied, the resale price "may be used if such method is more feasible and is likely to result in a more accurate determination of an arm's length price than the use of the cost plus method."

Under the resale price method, the arm's length price of a controlled sale is equal to the price at which it is anticipated that property purchased in the controlled sale will be resold by the buyer in an uncontrolled sale, reduced by an appropriate markup, and adjusted to reflect any material differences between the uncontrolled purchases and resales used as the basis for the calculation of the appropriate markup percentage and the resales of property involved in the controlled sale. Treas. Reg. § 1.482-2(e)(3)(i), (iv), and (ix). [redacted] contends that it determined the markup reduction on its controlled distributors' sales by reference to the markups on sales of similar competing products sold by distributors to unrelated retailers.

[redacted]s burden of proof with respect to establishing the validity of a fair market price computed under the resale price method is similar to its burden under the comparable uncontrolled price method. In this connection, section 1.482-2(e)(3)(vi) of the Regulations recognizes that appropriate markups may be determined from sales of unrelated parties if such sales involve similar products. The Regulation lists the following factors as important in determining similarity of products:

(a) The type of property involved in the sales....

(b) The functions performed by the reseller with respect to the property. For example: packaging, labeling, delivering, maintenance of inventory, minor assembly, advertising, selling at wholesale, selling at retail, billing, maintenance of accounts receivable, and servicing.

(c) The effect on price of any intangible property utilized by the reseller in connection with the property resold. For example: patents, trademarks, trade names.

(d) The geographic market in which the functions are performed by the reseller.

> In general, the similarity to be sought relates to the probable effect upon the markup percentage of any differences in such characteristics between the uncontrolled purchases and resales on the one hand and the controlled purchases and resales on the other hand. Thus, close physical similarity of the property involved in the sales compared is not required under the resale price method since a lack of close physical similarity is not necessarily indicative of dissimilar markup percentages.

Accordingly, as with the comparable uncontrolled price method, [redacted] bears a heavy burden of proof with respect to the fair market price computations under the resale price method. As to the latter method, [redacted] must establish the similarity of the products used to compute the appropriate markup reduction, and this will entail analysis of geographic markets and intangibles associated with the products, among other factors. Furthermore, [redacted] must prove that it has surveyed similarly-situated unrelated distributors for market data, and that such data has been properly analyzed. Economic assistance in making this evaluation is probably required.

Conclusions

It is IRS position that a taxpayer may, under some circumstances, offset section 482 adjustments attributable to other nonarm's length transactions. In this case, [redacted] contends that there existed a valid cost sharing agreement between it and its foreign subsidiaries and that the cost sharing payments made by the subsidiaries may be used to offset section 482 allocations that the IRS has determined with respect to inter-company pricing of products. It is the IRS's position that a valid cost sharing agreement did not exist in this case, because there was no written agreement. Treas. Reg. § 1.482-2(d)(4).

Assuming the absence of a valid cost sharing agreement, the "cost sharing payments" are recharacterized as assists, and to the extent the subsidiaries were not reimbursed by [redacted] for the value of the assists, the IRS may make section 482 allocations of income to the subsidiaries or the unreimbursed portions may be utilized as offsets to other IRS section 482 adjustments. Treas. Reg. § 1.482-2(d)(1)(ii)(b). It is likely that [redacted] will establish that its sale price computations did not include its research and development costs and, therefore, that the subsidiaries were not reimbursed for their assists.

If [redacted] should continue to argue that a valid cost sharing agreement existed between it and its subsidiaries, it must also establish that the agreement was comparable to an agreement that would have been worked out between unrelated parties, that [redacted]'s sale prices to its subsidiaries were fair market prices (before considering the cost sharing agreement), that it can prove the arm's length nature of its prices by appropriately using the comparable uncontrolled price and resale price methods, and that it can show the value of the intangibles embedded in its products that the subsidiaries are entitled to without paying further consideration. This memorandum does not provide you with definitive answers on these issues. These determinations will involve in-depth analyses, and it is probable that you would need the services of economists and/or engineers, if the question is not resolved by allowing [redacted] offsets for the unreimbursed value of the assists.

As we have previously stated, we will provide you with our views on the currency loss issue by subsequent memorandum. If you have any questions, please call Ed Williams at FTS 287-4851.

This memorandum responds to your first request for informal technical advice and does not constitute a formal technical advice memorandum. Because it discusses matters in anticipation of litigation, a copy of this memorandum should not be furnished to the taxpayer.

GEORGE M. SELLINGER